

# *Oversight Report*



REPORT ON QUALITY CONTROL REVIEW OF  
ARTHUR ANDERSEN, LLP, FOR  
OMB CIRCULAR NO. A-133 AUDIT REPORT OF THE  
HENRY M. JACKSON FOUNDATION FOR THE  
ADVANCEMENT OF MILITARY MEDICINE,  
FISCAL YEAR ENDED SEPTEMBER 30, 1998

Report Number D-2001-6-001

February 2, 2001

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<b>Abstract</b> We are providing this report for your review and comment. On December 15, 1998, the firm of Arthur Andersen, LLP (Arthur Andersen), issued the single audit report for the Henry M. Jackson Foundation for the Advancement of Military Medicine (the Foundation). The Foundation, based in Rockville, Maryland, is a non-profit organization that was chartered by Congress in 1983 to support military medical research and education and to promote public-private partnerships in that area. The audit is required by the Office of Management and Budget (OMB) Circular No. A-133, i-Audits of States, Local Governments, and Non-Profit Organizations, l. (the Circular A-133). For the fiscal year ended September 30, 1998, the Foundation reported total Federal expenditures of \$63.9 million consisting of \$53 million for the DoD and \$10.9 million for other Federal agencies.		
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### **Acronyms**

DCAA  
GAGAS  
OMB

Defense Contract Audit Agency  
Generally Accepted Government Auditing Standards  
Office of Management and Budget

February 2, 2001

President

Henry M. Jackson Foundation for the Advancement of Military Medicine

Partner

Arthur Andersen, LLP

**SUBJECT:** Report on Quality Control Review  
of Arthur Andersen, LLP, for OMB Circular No. A-133 Audit Report of  
the Henry M. Jackson Foundation for the Advancement of Military Medicine,  
Fiscal Year Ended September 30, 1998  
Report No. D-2001-6-001 (Project No. D2000-OA-0169)

We are providing this report for your review and comment. On December 15, 1998, the firm of Arthur Andersen, LLP (Arthur Andersen), issued the single audit report for the Henry M. Jackson Foundation for the Advancement of Military Medicine (the Foundation). The Foundation, based in Rockville, Maryland, is a non-profit organization that was chartered by Congress in 1983 to support military medical research and education and to promote public-private partnerships in that area. The audit is required by the Office of Management and Budget (OMB) Circular No. A-133, "Audits of States, Local Governments, and Non-Profit Organizations," (the Circular A-133). For the fiscal year ended September 30, 1998, the Foundation reported total Federal expenditures of \$63.9 million consisting of \$53 million for the DoD and \$10.9 million for other Federal agencies.

**Quality Control Review Objective.** As the cognizant agency for the Foundation, the Office of Inspector General, DoD, performed a quality control review to determine whether the FY 1998 audit report that the Foundation submitted to the Single Audit Clearinghouse met the applicable reporting standards and whether Arthur Andersen conducted the audit in accordance with applicable standards and the Circular A-133. See Appendix A for a discussion of the scope, prior quality control reviews related to Arthur Andersen, and single audit requirements.

**Review Results.** Arthur Andersen complied with the Circular A-133 in performing the audit of the financial statements and in reporting on internal controls and compliance related to the financial reporting. However, Arthur Andersen needed to improve the documentation and test of internal controls for compliance with requirements applicable to the major programs

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(finding A). Moreover, the Foundation did not ensure that the single audit required by the Circular A-133 was properly coordinated between Arthur Andersen and the Defense Contract Audit Agency (DCAA) (finding B).

**Finding A. Performance of FY 1998 Single Audit.** Arthur Andersen provided a complete reporting package that complied with the Circular A-133 for the financial statements and related reporting requirements. However, Arthur Andersen needed to improve the planning and execution of the review of compliance with requirements applicable to the major program. In addition, the working papers needed to better document the work performed to support the auditor conclusions on compliance with requirements.

**Review of Internal Control Over Compliance.** The Arthur Andersen working papers contained a general understanding of the Foundation's internal control system. Arthur Andersen properly identified which of the 14 compliance requirements applied to the 3 sampled Federal awards under the Foundation's major program, Research and Development. Appendix A shows the 14 compliance requirements and those that applied to the Foundation program. Arthur Andersen had an audit plan that assessed internal controls for financial statements. However, Arthur Andersen did not separately review and document each of the 5 components of internal control (control environment, risk assessments, control activities, information and communication, and monitoring) in general or for the 10 applicable compliance requirements.

Both generally accepted auditing standards and the generally accepted government auditing standards (GAGAS) require that to plan the audit, the auditor perform certain procedures in order to understand the design of controls and to determine whether the controls have been implemented. The Circular A-133 and the Compliance Supplement (Supplement) require the auditor to identify which of the 14 compliance requirements apply to the major programs and to evaluate the 5 components of internal control for each applicable requirement. The understanding obtained from this assessment must be documented in the working papers to support the audit plan.

The Arthur Andersen standard audit program did not include steps for reviewing the five components separately for each relevant compliance requirement. However, Arthur Andersen relied heavily on guidance provided by the Supplement when auditing each applicable compliance requirement. Therefore, the audit planning deficiencies were partially offset by the method used to execute the actual audit work. Arthur Anderson can ensure a more efficient and adequate audit by assessing, as part of its planning process, the five components of internal control.

**Review of Internal Control Over Compliance Requirements.** The working papers contained some evidence that testing of controls was performed; however, the working papers did not contain a sufficient description of the sampling plan or documentation of the testing done as required by GAGAS.

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**Documentation of Sampling Plan.** The working papers did not explain which specific testing methodology or criteria for each transaction reviewed was used to determine when the cost was allowable under the OMB Circular No. A-122, “Cost Principles for Non-Profit Organizations.” Therefore, we in turn could not determine which of the specific procedures were applied to test each Federal award. Specifically, the working papers did not include sufficient information on the sampling plan to support its use in fulfilling the compliance requirement testing on cost allowability. The Arthur Andersen sampling objectives were not specific and did not identify whether a cost was charged directly or indirectly, and whether it was for materials, overhead, or labor. The sampling plan did not identify the allowability criteria in OMB Circular No. A-122 that was being tested. The sampling plan should have identified the population and its characteristics for testing cost allowability.

**Documentation of Compliance Testing.** Compliance requirement testing consists of examining transactions to provide auditors with sufficient evidence to support an opinion on compliance. Of the 10 applicable compliance requirements audited, we re-tested 3. The working papers for one of the three, “Reporting,” included sufficient documentation to support the audit conclusion. However, the working papers for the other two compliance requirements, “activities allowed/unallowed” and “allowable costs/cost principles,” did not adequately document the work performed. GAGAS requires that the form and content of the working papers should allow an experienced auditor to determine the evidence that supports the auditor’s significant conclusions and judgments.

In general, the working papers should document the objectives, scope, and methodology, including the sampling criteria the auditors used. We could not determine the adequacy of the work performed because insufficient evidence existed in the working papers to support the audit judgments and conclusions. The working papers contained only a check number identifying what was tested. Specifically, the working papers should also identify the Federal award number, name and type (such as grant, cooperative agreement or contract) and voucher documents reviewed (such as an invoice or purchase order).

In addition, the working papers should include an adequate description of transactions tested, such as showing the type of cost (labor, material, or overhead), its amount, and date/time period, as well as whether it was charged directly or indirectly.

However, through re-testing selected compliance requirements, we were able to draw the same conclusions as Arthur Andersen. Therefore, we accepted the audit conclusions despite the inadequate documentation.

**Summary.** Arthur Andersen’s working papers were insufficient to support their conclusions concerning compliance with requirements. However, through re-testing and other means, we were able to obtain reasonable assurance of the conclusions drawn by Arthur Andersen. In conducting future single audits, Arthur Anderson should:

- review and document the five internal control components for each applicable compliance requirement;

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- properly document any sampling plan used; and
  - adequately document the tests performed on the compliance requirements including criteria, judgments, and conclusions.

## Recommendations

### A. We recommend that Arthur Andersen, LLP:

1. Revise its audit program for the single audit to comply with the requirements of the Circular A-133 to include audit steps that document an understanding of the 5 internal control elements related to each of the applicable 14 compliance requirements.

2. Improve the working papers by documenting its judgments, procedures, and results or conclusions with relevant and sufficient evidence, including the sampling plan.

**Finding B. Coordination of Single Audit.** The Foundation should better coordinate the single audit. Although Arthur Andersen relied on the DCAA audit of indirect cost and cost allocations as support for the review of compliance with requirements, better coordination would result in more efficient and economical use of each audit organization's work. The Single Audit Act and the Circular A-133 require that audits be planned in such a way as to build on audit work performed by others.

**Coordination Between Audit Organizations.** In November 1998, the Foundation engaged Arthur Andersen to provide all FY 1998 audit services required to meet the intent of the Circular A-133. The Arthur Andersen engagement letter did not mention coordination of the single audit work with DCAA. The DCAA also performed work at the Foundation on the allowability of direct costs and indirect cost rates for establishing negotiated carryforwards as part of an incurred cost review. However, neither the DCAA nor the Arthur Andersen working papers documented any coordination between the audit organizations to determine the work each should perform so that they could rely on each other's work, avoid possible duplication of effort, and better fulfill the Circular A-133 requirements.

Despite the lack of pre-audit coordination, Arthur Andersen, after reviewing DCAA audit files, relied on DCAA audit work relating to indirect cost allocations. However, both audit organizations did testing of the "allowable cost/cost principles" requirement. Although DCAA reviewed Arthur Andersen working papers for the allowable cost/cost principles requirements, they were unable to totally use the already completed work because of inadequate documentation.

In addition, Arthur Andersen did not identify additional pertinent DCAA audit work that they could have relied on. On September 30, 1998, DCAA issued a report on "Audit of Contractor's Timekeeping System." The audit reviewed the allocability of labor costs to appropriate cost objectives and could have been relied on by Arthur Anderson to support its acceptance of the Foundation labor costs. Without the DCAA audit report, the Arthur



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Andersen work relating to labor costs would have been inadequate, and additional audit work would have been required to properly complete the FY 1998 audit.

**Summary.** To increase efficiency and achieve a more cost-effective audit, the Foundation must recognize its responsibility in better coordinating the single audit. Better pre-audit coordination would have allowed reliance on each other's work and may have eliminated some of the deficiencies we identified in the review of internal control over compliance.

## **Recommendation**

B. We recommend that the Director of Accounting, Henry M. Jackson Foundation, coordinate the audit between the independent public accountant retained to perform the single audit and the Defense Contract Audit Agency to avoid duplication and to achieve a complete and cost-effective audit. The engagement letter should include the requirement to attend a coordination meeting prior to beginning the audit.

**Comments Required.** Because this report contains findings and recommendations, written comments are required. Please provide your comments, including appropriate corrective actions, to us by March 7, 2001. We appreciate the courtesies extended during the review. If you have questions on this report, please contact Mr. Wayne C. Berry at (703) 604-8789 (wberry@dodig.osd.mil) or Mr. Martin I. Gordon at (703) 604-8738 (mgordon@dodig.osd.mil). The report distribution is at Appendix B. The evaluation team members are listed inside the back cover.

Patricia A. Brannin  
Deputy Assistant Inspector General  
for Audit Policy and Oversight

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# **Appendix A. Quality Control Review Process**

## **Scope and Methodology**

We conducted a quality control review of Arthur Anderson, LLP, audit of the Henry M. Jackson Foundation for the Advancement of Military Medicine (Foundation) for the fiscal year ended September 30, 1998, and the resulting reporting submission to the Single Audit Clearinghouse dated March 11, 1999. We performed our review using the 1999 edition of the “Uniform Quality Control Guide for the A-133 Audits” (the Guide). The Guide applies to any single audit that is subject to the requirements of OMB Circular A-133, “Audits of States, Local Governments, and Non-Profit Organizations,” revised June 24, 1997 (the Circular A-133). The Guide is the approved checklist of the President’s Council on Integrity and Efficiency for performing the quality control review procedures. We reviewed the audit as required by the Circular A-133, GAGAS issued by the Comptroller General of the United States, and generally accepted auditing standards issued by the American Institute of Certified Public Accountants. Our review was conducted from May 2000 through January 2001 and covered areas related to the financial statements and a major program, categorized as a cluster program of research and development. As the cognizant audit agency for the Foundation, we focused our review on the following qualitative aspects of the single audit:

- Qualifications of auditors
- Independence
- Due professional care
- Quality control
- Planning and supervision
- Internal control and compliance testing
- Schedule of Expenditures of Federal Awards
- Schedule of Findings and Questioned Costs
- Data Collection Form

## **Prior Quality Control Reviews**

We performed one quality control review for FY ending 1993 that concluded the audit satisfied the Circular A-133 requirements. We also did three desk reviews for FYs of 1991, 1995, and 1996, with no reportable conditions.

## Single Audit Requirements

The Circular A-133 establishes policies to guide implementation of the Single Audit Act 1984 (Public Law 98-502) and the Single Audit Act Amendments of 1996 (Publication 104-156). The Circular A-133 provides an administrative foundation for uniform audit requirements for non-Federal entities that administer Federal awards. In addition, the Circular A-133 serves to ensure that Federal departments and agencies rely on and use the audit work to the maximum extent practicable. To meet the intent of the law and the Circular A-133, a complete reporting package on each single audit is submitted to the Single Audit Clearinghouse from the auditee (non-Federal entity) that includes the following:

- Data collection form certified by the auditee that the audit was completed according to the OMB Circular A-133;
- Financial statements and related opinion;
- Schedule of Expenditures of Federal Awards and related opinion;
- Report on internal control and compliance review related to the financial statements;
- Report on internal control over compliance and on compliance with laws, regulations, and the provisions of contracts or grant agreements, and related opinion on compliance of major programs; and
- Schedule of Findings and Questioned Costs.

OMB issues a Compliance Supplement (the Supplement) annually. The Supplement assists the auditors in determining the audit scope for the Circular A-133 requirements for review of internal control. For each compliance requirement, the Supplement describes the objectives of internal control and certain characteristics that when present and operating effectively may ensure compliance with program requirements. The Supplement gives examples of the common characteristics for the five components of internal control (control environment, risk assessment, control activities, information and communication, and monitoring) for each compliance requirement. The following 14 compliance requirements applicable to the various Federal programs are identified in the Supplement:

A.	Activities Allowed/Unallowed	*H.	Period of Availability of Federal Funds
*B.	Allowable Costs/Cost Principles	*I.	Procurement and Suspension and Debarment
*C.	Cash Management	*J.	Program Income
*D.	Davis-Bacon Act	K.	Real Property Acquisition/Relocation Assistance
E.	Eligibility of Federal Funds	*L.	Reporting
*F.	Equipment and Real Property Management	M.	Subrecipient Monitoring
G.	Matching, Level of Effort, Earmarking	*N.	Special Tests and Provisions

\* Compliance requirements applicable to reviewed Federal awards at the Henry M. Jackson Foundation.

## Appendix B. Report Distribution

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